Using Internal Controls to Improve Accounting and Reporting

William Hall
Senior Financial Consultant
Vermont League of Cities and Towns
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Using Internal Controls

- Overview of internal control
- COSO framework
- Control-related policies and procedures
- Best practices

Embezzlement/Fraud/Errors

- Embezzlement
  - To make away with, to steal, plunder
- Fraud
  - An act of deceiving or misrepresenting
- Error
  - An unintentional mistake that results in misleading financial reporting

Internal Control Overview

- Why do we need internal controls?
  - Safeguard resources
  - Maintain accurate financial data
  - Report financial information in a timely and accurate manner
  - Adhere to laws and regulations

Internal Control Overview

- Inherent limitations of internal controls
  - Judgment
  - Breakdowns
  - Management override
  - Collusion
- Cost versus benefit

Internal Control Overview

- How are auditors impacted?
  - Understanding the internal control system and how it works will determine how you approach your audit
  - You may be an integral part of the internal control system
  - Part of your role as auditors is to make suggestions for improvements to financial operations

COSO Framework

- Three components of fraud
  - Pressure
  - Rationalization
  - Opportunity
- Opportunity is the component we can have an impact on

COSO Framework

- Committee of Sponsoring Organizations
  - American Accounting Association
  - American Institute of Certified Public Accountants
  - Financial Executives International
  - Institute of Management Accountants
  - Institute of Internal Auditors
- Initial framework released in 1992
- Updated framework released in 2012

COSO Framework

- Framework consists of five essential components
- Seventeen principles support these five components
- Supporting each principle are points of focus to help management in designing and implementing internal controls
- http://www.coso.org/ic.htm

COSO Framework

- Internal control is
  - *a process* with ongoing tasks and activities
  - *effected by people* at all levels of government
  - *designed to provide reasonable assurance*, not absolute assurance
  - *regarding the achievement of objectives* in reliability of reporting, compliance with laws and objectives, and effectiveness of operations

Five Essential Elements of Internal Control

- Sound Control Environment
- Regular Ongoing Assessment of Risk
- Design and Implementation of Control-related Policies and Procedures
- Effective Communication
- Ongoing Monitoring of Control-related Policies and Procedures

Control Environment

- Senior management establishes the "tone at the top" regarding importance of internal control and expected standards of conduct
  - Commitment to integrity and ethical values
  - Exercises oversight responsibility for development of controls
  - Establishes structure, authority and responsibility
  - Commitment to competence
  - Enforces accountability

Risk Assessment

- Process that *identifies and analyzes risks* to achieving the government's objectives, and *determines how to address those risks*
  - Specify relevant objectives
  - Identify and analyze risks
  - Assess fraud risk
  - Identify and analyze significant changes

Fraud Risk Assessment

- A seemingly overwhelming task
  - Start somewhere
  - Go where the money is
  - Get buy-in from elected and appointed officials
  - Involve as many employees as possible
  - Document everything

Fraud Risk Assessment

- Five Step Plan
  - Step 1 – Gather information about the government and its environment
  - Step 2 – Analyze the information and consider whether fraud conditions exist
  - Step 3 – Identify the risks of material misstatement (likelihood and significance)
  - Step 4 – Assess fraud risks and develop control activities
  - Step 5 – Report on results

Control Activities

- Actions established by policies and procedures to mitigate risks identified in the risk assessment
  - Select and develop control activities
  - Select and develop general controls over technology
  - Implement controls through policies and procedures

Control-related Policies and Procedures

- Adopt financial policies
  - Documents the various responsibilities and lines of authority
  - Communicates expectations of how financial transactions will be reported
  - Enables a discussion of how the town would like its finances to be handled

Control-related Policies and Procedures

- Document procedures
  - Spell out how each process is supposed to be handled, who does what and how
- Document control activities
  - Prevention controls
  - Detection controls
  - Avoidance controls

Control-related Policies and Procedures

- Compensating controls
  - Segregation of duties
  - Authorization of transactions
  - Periodic reconciliation and verification
  - Timely financial statements
  - Analytical review
  - Security of assets and records
  - Properly designed records

Information and Communication

- Policies and procedures are communicated to all appropriate personnel
- Communication from staff of procedures that are no longer working or need to be improved

Monitoring

- Policies and procedures need to be reviewed on a regular basis to make sure they function at optimal efficiency
  - On-going risk assessment
  - As risks change, policies and procedures should change

Best Practices - General

- Demonstrate a commitment to competence
- Document policies, procedures and practices
- Take steps to reduce the opportunity to commit fraud
  - Annual vacations for accounting employees
  - Proper supervision and review of employees' work
  - Regular financial reporting and review of budgetary status
  - Bonding of all employees who handle municipal funds

Best Practices – Financial Records

- Establish and maintain adequate systems and processes for accounting and reporting
  - Allow financial transactions to be recorded, easily retrieved for analysis, and provide for generation of timely financial reports
  - Approval of general journal entries by management
- Maintain proper separation of duties
  - Bank reconciliations should be performed by someone not involved in the receipt or disbursement process
  - Perform regular reconciliations of other accounts
  - All financial recording documents should be pre-numbered and all forms should be accounted for
  - Safeguard accounting records

Best Practices - Cash

- Establish adequate processes for safeguarding receipts
  - Adopt a cash receipts policy
  - Restrictively endorse checks on receipt and deposit on a timely basis
  - Prepare duplicate receipts for all transactions
- Establish adequate processes for safeguarding disbursements
  - All disbursements by check or direct deposit
  - Select board orders must be prepared for all purchases and signed by a majority of the board
  - Petty cash funds (when needed) should be handled on an imprest, or fixed amount, basis

Best Practices – Accounts Receivable and Collections

- Establish and maintain process that will ensure that account balances are correct
  - Maintain adequate separation of duties
  - Record all receivables in the general ledger (taxes, utilities, miscellaneous)
- Establish and maintain process that will ensure that outstanding amounts due are collected
  - All invoices for all departments should be forwarded to finance office for processing
  - Prepare regular aged listing of receivables
  - Send regular statements to all customers
  - Charge interest and penalties on all overdue accounts

Best Practices – Purchasing and Disbursements

- Establish and maintain processes that ensure adequate oversight
  - Adopt a purchasing policy
  - Implement a purchase order system
  - Maintain adequate separation of duties
  - Ensure proper approval of all invoices
  - Install procedures to detect fictitious vendors and duplicate payment of invoices

Best Practices - Payroll

- Establish and maintain adequate systems for ensuring accuracy and oversight
  - Maintain a personnel file that includes hiring and compensation information and authorization for all deductions
  - Salary and wage information must be adopted annually by the select board for all employees
  - All payroll changes should be authorized by someone who does not process payroll
  - Use direct deposit for payment of net pay
  - Adopt leave policies and properly document the accumulation and use of leave time

Best Practices – Grand List and Tax Records

- Establish and maintain adequate process to ensure that records are accurate
  - Make certain all properties are included in the grand list (including improvements)
  - Changes to values should be maintained and reconciled on a regular basis
  - Reconciliation of tax receivables with tax receipts and tax adjustments on a monthly basis by someone other than the tax collector
  - Adopt policies concerning collection actions, and follow up on delinquencies

Best Practices – Property and Equipment

- Establish and maintain adequate systems and processes to ensure that schedules are accurate and inventory is secure
  - Prepare and maintain fixed asset schedules and conduct periodic follow-up
  - Maintain proper security
  - Review insurance coverage to determine its adequacy

Best Practices – Information Systems

- Establish and maintain adequate systems and processes to ensure that data is secure
  - Limit access to financial records to those who require specific access
  - Back up computer records regularly and store back-up copies off site
  - Use passwords to protect all financial information and change them on a regular basis

Internal Control Checklist

- VLCT Internal Control Checklist
  - http://www.vlct.org/assets/MAC/vlct_municipal_internal_controls_checklist.pdf
  - Designed to assist in reviewing internal controls

Questions

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